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In the Supreme Court of the United States

OCTOBER TERM, 1993

VICTOR TEICHER, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioners' trading in securities while in possession of material non-public information that was misappropriated from its rightful owners violated the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5.

2. Whether the court of appeals correctly concluded that, even assuming the district court erred in not instructing the jury that the misappropriated information must be the cause or a basis of petitioners' trades, the omission of that instruction was harmless because no reasonable jury could have concluded that petitioners did not trade on the basis of the information.

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OPINIONS BELOW

The opinion of the court of appeals, Pet. App. 1a-21a, is reported at 987 F.2d 112. The opinion of the district court, Pet. App. 22a-62a, is reported at 785 F. Supp. 1137.

JURISDICTION

The judgment of the court of appeals was entered on March 2, 1993. A petition for rehearing was denied on April 26, 1993. Pet. App. 63a-64a. The petition for a writ of certiorari was filed on July 23, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Following a jury trial in the United States District Court for the Southern District of New York, petitioners were convicted of conspiracy to commit securities fraud and mail fraud (Count 1), in violation of 18 U.S.C. 371. In addition, petitioners Teicher and Victor Teicher & Co. were convicted on nine counts of securities fraud (Counts 2-10), in violation of Sections 10(b) and 32 of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b) and 78ff, and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5; and two counts of fraud in connection with a tender offer (Counts 11-12), in violation of Sections 14(e) and 32 of the Exchange Act, 15 U.S.C. 78n(e) and 78ff, and Rule 14e-3 thereunder, 17 C.F.R. 240.14e-3. Petitioner Teicher was also convicted on two counts of mail fraud (Counts 13-14), in violation of 18 U.S.C. 1341. Petitioner Frankel was convicted on one count of securities fraud (Count 8), in violation of Sections 10(b) and 32 of the Exchange Act, and Rule 10b-5; one count of mail fraud (Count 15); one count of perjury (Count 16), in violation of 18 U.S.C. 1621; and two counts of obstruction of justice (Counts 17-18), in violation of 18 U.S.C. 1505. Teicher was sentenced to 18 months' imprisonment to be followed by five years' probation, and was fined $200,000. Victor Teicher & Co. was fined $600,000. Frankel was sentenced to 18 months' imprisonment and was fined $10,000. The district court denied petitioners' post-trial motions, Pet. App. 22a-62a, and the court of appeals affirmed, *id.* at 1a-21a.

1. Petitioners engaged in a scheme to trade securities after wrongfully obtaining material, non-public information concerning tender offers and other corporate acquisition bids. Teicher, an arbitrageur, formed Victor Teicher & Co. (Teicher & Co.), an investment firm through which he managed investment pools for individual

investors. Frankel was a research analyst in the arbitrage department of Drexel Burnham Lambert, Inc. (Drexel).[1] Pet. App. 3a.

From December 1985 until March 1986, Michael David, an associate in the corporate department of the law firm of Paul, Weiss, Rifkind, Wharton & Garrison (Paul Weiss), regularly provided Teicher with confidential, non-public information that David obtained concerning possible corporate acquisitions by Paul Weiss clients. Pet. App. 4a.[2] Teicher then traded while in knowing possession of the wrongfully obtained information. *Id.* at 4a-8a. Frankel supervised Robert Salsbury, a financial analyst in Drexel's research unit. *Id.* at 4a. Salsbury provided Teicher with the names of companies on Drexel's highly confidential list of firms that were the subjects of mergers or takeovers by Drexel clients and in which trading by Drexel personnel was prohibited. *Ibid.* Teicher traded while in knowing possession of that information. *Id.* at 9a-10a. Frankel also received a tip from David, relayed by Salsbury, and traded while in knowing possession of that material non-public information. *Id.* at 8a.

a. In early February 1986 David tipped Teicher about a possible takeover attempt of American Can Corporation by Paul Weiss client Triangle Industries. Pet. App. 4a. David told Teicher that he "had learned within Paul Weiss that American Can at sometime in the future may

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[1] Arbitrage, as it applies here, entails trading in securities in companies that are the subjects of changes in corporate control in order to take advantage of fluctuations in the prices of those securities. Pet. App. 3a.

[2] David also provided Andrew Solomon, a trader at the brokerage firm of Marcus Schloss, Inc., with the same Paul Weiss information he disclosed to Teicher. Solomon, in turn, provided other confidential information to David, who then passed it on to Teicher. Pet. App. 4a.

become a takeover target by a Paul Weiss client, Triangle Industries" and that "if it would happen at all it would happen within six months." *Id.* at 5a. On February 6, 1986, Teicher bought 5,000 shares of American Can common stock and hedged his position by selling 50 call options on the stock. The following day, Teicher sold the shares and purchased 50 call options for a profit of $1,862. *Ibid.*

b. The second tip from David involved a takeover attempt of Avondale Mills by Paul Weiss client Dominion Textile Inc. Pet. App. 5a. David obtained information about that attempt from discussions with the Paul Weiss librarian and from snooping among Paul Weiss library notebooks, which disclosed that Paul Weiss attorneys had requested, on behalf of Dominion, Avondale's SEC filings and other documents concerning Avondale. *Id.* at 5a-6a. On February 21, 1986, David telephoned Teicher and told him that "Dominion Textile is going to make a bid for Avondale Mills." *Id.* at 5a-6a. Later that day, Teicher placed an order for 20,000 shares of Avondale stock but was able to purchase only 3,500 shares.[3] After Dominion Textile announced its tender offer for Avondale Mills, Teicher sold all his shares of Avondale Mills for a profit of approximately $37,000. *Id.* at 6a.

Following the announcement of a competing tender offer, David tipped Teicher that Dominion would be making a second bid. On March 14, 1986, Teicher & Co. accounts purchased 9,300 shares of Avondale Mills stock and also sold 3,000 shares that same day. On March 18, after Dominion Textile announced a second tender offer for Avondale Mills stock, Teicher began selling his remaining shares for a final profit of $14,000. Pet. App. 6a-7a.

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[3] Teicher & Co. made additional purchases of 9,400 shares on February 24 and 1,800 shares on February 26. Pet. App. 6a.

c. In early February 1986, David uncovered acquisition plans by Paul Weiss client Ampco-Pittsburgh, again by snooping in the Paul Weiss library for requests by firm lawyers for SEC documents. Pet. App. 7a. David then tipped Teicher that Ampco-Pittsburgh was "looking very closely" at Allegheny International. On March 7, 1986, David told Teicher "it must be happening." On the same day, Teicher purchased 10,000 shares of Allegheny stock, which he sold on March 10 for a profit of $3,300. *Ibid.*

d. On March 10, David tipped Teicher that a takeover bid for American Brands would be made by Paul Weiss client BAT Industries. David had learned that information by looking at a list of new business at Paul Weiss and again by looking at requests for SEC documents in the Paul Weiss library. Pet. App. 7a-8a. That same day, Teicher purchased 10,200 shares of American Brands and allowed David to purchase 10 American Brands call options through a Teicher & Co. account. Teicher prohibited David from purchasing the options in his own name, because to do so would leave a "smoking gun." In addition, on March 13 and March 25, Frankel, after being tipped by Salsbury (who had been tipped by David), purchased American Brands options. *Id.* at 8a.

e. On March 11, 1986, David tipped Teicher with information, which he had obtained from one of his co-conspirators at the brokerage firm of Marcus Schloss, Inc., regarding the price that would be paid in connection with a leveraged buyout of Revco, D.S. That same day, Teicher sold short 5,000 shares of Revco stock, Pet. App. 8a-9a, which he subsequently covered by purchasing 5,000 shares following a $1 fall in the stock price. Teicher realized a profit of $4,900 on the Revco transactions. *Id.* at 9a.

f. Teicher traded the securities of three companies after being tipped that they were on Drexel's list of

acquisition targets. Pet. App. 9a-10a. In early January 1986, Frankel and Salsbury tipped Teicher that Drexel had been hired by Republic Airlines, Inc., in connection with a proposed merger with NWA, Inc., the parent company of Northwest Airlines. On January 8, Teicher began purchasing shares in Republic, and by January 24 he had accumulated 23,900 shares. Following the announcement of the merger, Teicher sold his entire position for a profit of $80,000. *Id.* at 9a. In mid-December 1985, Salsbury tipped Teicher that Northeast Savings Bank had hired Drexel in connection with its contemplated takeover of Westchester Financial Services Corporation. On January 14, 1986, Teicher purchased 2,000 shares of Westchester Financial stock, which he sold on February 3, for a $1,500 profit. On March 13, 1986, Salsbury tipped Teicher that Drexel had been retained by W Acquisition Corporation to assist in an attempted takeover of Warnaco, Inc. The next day, Teicher purchased 20,000 shares of Warnaco stock, which he sold for a profit of $40,000 following Warnaco's announcement of a tender offer. *Id.* at 9a-10a.

2. The court of appeals affirmed. Pet. App. 1a-21a. Petitioners claimed that the district court committed reversible error by instructing the jury that petitioners could be found guilty of securities fraud for trading while in possession of fraudulently obtained material non-public information, "without regard to whether this information was the actual cause of the sale or purchase of securities." *Id.* at 15a. While observing that "[a] number of factors weigh in favor of a 'knowing possession' standard" and against a causation standard, *id.* at 18a, the court of appeals held that it was "unnecessary to determine whether proof of securities fraud requires a causal connection, because any alleged defect in the instruction was harmless beyond doubt." *Id.* at 19a.

The court indicated that this case involves arbitrageurs, who are in the business of gathering "tidbits" of information to develop trading strategies. Pet. App. 19a. "By their own admission, Teicher and Frankel actively sought and received such 'tidbits' in order to weave them into a material whole upon which they traded." *Id.* at 19a-20a. The court rejected the notion that "when one such piece of information is revealed to be material, in and of itself, and the trader knows it to be material, the trader might somehow consider the information irrelevant to the whole." *Id.* at 20a.

The court then found that "the question of what Teicher and Frankel believed about the tipped information was properly placed before the jury," and that "the district court's charge did not preclude Teicher and Frankel from arguing, as they did, that they 'never knowingly sought, obtained, or traded upon material nonpublic information from either David or Salsbury.'" Pet. App. 20a. The court noted, however, that petitioners' theory at trial "was not that they did not *rely* on the material information they knowingly possessed," but rather that "they either did not *know* the information was material and nonpublic or did not *know* the information to be wrongfully acquired." *Ibid.*

After quoting the district court's instruction that petitioners were entitled to be acquitted if they "at all relevant times acted in good faith," the court of appeals concluded that "[i]t strains reason to argue that an arbitrageur, who traded while possessing information he knew to be fraudulently obtained, knew to be material, knew to be nonpublic,—and who did not act in good faith in so doing—did not also trade on the basis of that information." Pet. App. 21a. The court found "that on the

facts of this case, no reasonable jury could have made such a distinction." *Ibid.*[4]

ARGUMENT

1. Petitioners seek review (Pet. 9-13) of the court of appeals' holding that the misappropriation theory is a valid basis for liability under the securities laws. Under that theory, the fraudulent misappropriation of material non-public information in connection with the purchase or sale of securities violates Section 10(b) of the Exchange Act and Rule 10b-5. The misappropriation theory of liability has been accepted by every court of appeals that has considered the issue. See *SEC* v. *Cherif*, 933 F.2d 403 (7th Cir. 1991), cert. denied, 112 S. Ct. 966 (1992); *SEC* v. *Clark*, 915 F.2d 439 (9th Cir. 1990); *SEC* v. *Materia*, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); *United States* v. *Newman*, 664 F.2d 12 (1981), aff'd after remand, 722 F.2d 729 (2d Cir.) (Table), cert. denied, 464 U.S. 863 (1983). See also *Rothberg* v. *Rosenbloom*, 771 F.2d 818, 825 (3d Cir. 1985) (Higginbotham, J., concurring). Petitioners do not claim that there is any conflict among the lower courts with respect to the validity of the misappropriation theory.

The theory is also fully consistent with this Court's decisions. There is no merit to petitioners' contention that the misappropriation theory "is entirely without foundation in this Court's prior interpretations of the securities laws." Pet. 12. Section 10(b) prohibits the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance" in violation of rules promulgated by the SEC. 15 U.S.C. 78j(b). Rule 10b-5, in turn, prohibits "any person" from engaging in "any act [or] practice" that

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[4] The court of appeals also rejected petitioners' argument that Salsbury was biased against them. Pet. App. 13a-15a. Petitioners do not renew that claim here.

"operates or would operate as a fraud or deceit upon any person" in connection with the purchase or sale of securities. 17 C.F.R. 240.10b-5. This Court has consistently construed those provisions broadly, noting that Section 10(b) is "a 'catchall' clause to enable the Commission 'to deal with new manipulative or cunning devices,'" *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 203 (1976) (brackets omitted), and that the statute and rule "are obviously meant to be inclusive." *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972). See also *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386 (1983); *United States* v. *Naftalin*, 441 U.S. 768, 773 (1979).

Contrary to petitioners' contention (Pet. 12) this Court's decisions in *Chiarella* v. *United States*, 445 U.S. 222 (1980), and *Dirks* v. *SEC*, 463 U.S. 646 (1983), do not raise doubts as to the validity of the misappropriation theory. Neither case was brought under the misappropriation theory; rather, both cases were brought on the theory that investors who traded with persons in possession of material non-public information were the victims of fraud by virtue of the nondisclosure of the information. See *Dirks*, 463 U.S. at 653-654; *Chiarella*, 445 U.S. at 228-230. Neither decision rejects the misappropriation theory, which posits that the source of the information was the victim of the fraud. In *Chiarella*, the Court held that, because the misappropriation theory had not been presented to the jury, the conviction could not be affirmed on the basis of that theory. 445 U.S. at 235-236.[5] In *Dirks*, the issue did not arise because, as the Court was careful to note, the defendant did not misappropriate

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[5] The four Justices who spoke to the issue, however, suggested that misappropriation could be a valid basis for imposing fraud liability. See 445 U.S. at 239 (Burger, C.J., dissenting); *id.* at 238-239 (Brennan, J., concurring in the judgment); *id.* at 245 (Blackmun, J., joined by Marshall, J., dissenting).

any information. 463 U.S. at 665. Since *Dirks* and *Chiarella*, this Court, rather than questioning the validity of the misappropriation theory, has suggested that trading on "misappropriate[d] or illegally obtain[ed] information" constitutes fraud in violation of Rule 10b-5. *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299, 313 n.22 (1985), quoting *Dirks*, 463 U.S. at 665.[6]

Contrary to petitioners' assertion (Pet. 11), the issue on which the Court was "divided four-to-four" in *Carpenter* v. *United States*, 484 U.S. 19 (1987), is not the issue presented in this case. In *Carpenter*, a *Wall Street Journal* reporter provided certain individuals with advance notice of the timing and contents of upcoming columns concerning public companies; those individuals then traded in securities of those companies in the expectation that publication of the columns would influence stock prices. The contents of the columns were not the confidential property of companies who traded securities; rather, the columns were, before publication, the confidential property of the Journal. *Id.* at 22-24. Accordingly, "the only alleged victim of the fraud" was the *Journal*, which "was not a buyer or seller of the stocks traded in or otherwise a market participant." *Id.* at 24. This Court affirmed the convictions under the securities laws by an equally divided vote. *Ibid.* The question

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[6] Congressional committees have also viewed the misappropriation theory as a valid basis for liability under the securities laws. See H.R. Rep. No. 910, 100th Cong., 2d Sess. 26-27 (1988) (the misappropriation theory "fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful"); H.R. Rep. No. 355, 98th Cong., 1st Sess. 5 (1983) ("In other areas of the law, deceitful misappropriation of confidential information by a fiduciary * * * has consistently been held to be unlawful"[;] * * * [Congress] "has not sanctioned a less rigorous code of conduct under the federal securities laws.").

presented, however, was not the general validity of the misappropriation theory, but the narrower question of the validity of the theory as it applies to fraud on entities that were not market participants.[7] Here, in contrast, the victims of petitioners' frauds were entities that were actively considering participating in the securities markets, and their agents—the law firms and investing banking firms they had entrusted with confidential information about those plans.

Not only do petitioners err in asserting that the misappropriation theory conflicts with this Court's cases, but they also err in contending (Pet. 12) that the misappropriation theory is invalid because it "is aimed at a fraud that is remote from the securities transaction." Rule 10b-5 proscribes fraud committed on any person "in connection with" a securities transaction. The Court has construed the "in connection with" language expansively. See *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). See also *United States* v. *Naftalin*, 441 U.S. 768 (1979) (in government enforcement action the victim of securities fraud need not be a purchaser or seller, or even an investor).

Misappropriation of market-sensitive information and subsequent trading while in possession of that information satisfies the "in connection with" requirement. The fraud in such a case is integrally tied to securities trading, because the very reason for misappropriating the information is to take advantage of it in a securities trans-

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[7] The Court in *Carpenter* explained: "The courts below rejected petitioners' submission, which is one of the two questions presented here, that criminal liability could not be imposed on petitioners under Rule 10b-5 because 'the newspaper is the only alleged victim of fraud and has no interest in the securities traded.'" 484 U.S. at 24. The other question presented was whether the same scheme violated the mail fraud statute; the Court unanimously held that it did. *Id.* at 25-28.

action. To the misappropriator, the information "has no value whatsoever except 'in connection with' his subsequent purchase of securities." *Materia*, 745 F.2d at 203. Particularly where, as here, the source of the information is itself contemplating or engaged in market activity in reliance on the confidentiality of the stolen information, there can be no doubt that the fraud is within the coverage of Rule 10b-5.

2. Petitioners also seek review of what they term the court of appeals' "conclusion" (Pet. 13) that the government need not prove that petitioners used the information they misappropriated in engaging in securities transactions, because proof of possession of the information suffices. The court of appeals, however, never decided that issue. The court simply noted petitioners' contention and listed four factors that it stated "weigh in favor of a 'knowing possession' standard." Pet. App. 18a. Such tentative consideration of an issue does not merit review.[8] *Black* v. *Cutter Laboratories*, 351 U.S. 292, 297 (1956) (the Court "reviews judgments, not statements in opinions").

The holding of the court of appeals was that "it is unnecessary to determine whether proof of securities fraud requires a causal connection, because any alleged defect in the instruction was harmless beyond doubt." Pet. App. 19a. That holding is correct, factbound, and not worthy of this Court's review. Contrary to petitioners' contention that the court of appeals' reliance on harmless error was "wholly illusory," because it was based on facts—the presence of scienter and the lack of good faith

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[8] As noted in an article on which petitioners repeatedly rely (see Pet. 16, 21, 23-24 & n.16, 27), the causation issue "was not dispositive even in *Teicher*" and "the *Teicher* court merely hinted at a possession standard." Pitt & Groskaufmanis, *Actual Use of Inside Information at Issue*, Nat'l L. J., at 20, 22 (June 21, 1993).

by petitioners—that are not "unique to the record in this case," but will exist "[i]n *every* prosecution under the statute and Rules" (Pet. 25) the court based its harmless error holding on the specific circumstances of this case.

The court began by noting that petitioners were professional arbitrageurs, whose business it is to seek out and compile various rumors and non-public pieces of information "in order to weave them into a material whole upon which they traded." Pet. App. 19a-20a. The court observed that at trial "Teicher and Frankel's defense theory was not that they did not *rely* on the material information [obtained from Paul Weiss and Drexel] they knowingly possessed. Rather, they argued that they either did not *know* the information was material and nonpublic or did not *know* the information to be wrongfully acquired." *Id.* at 20a. In light of the jury's rejection of those defenses, the court stated that

> [i]t strains reason to argue that an arbitrageur, who traded while possessing information he knew to be fraudulently obtained, knew to be material, knew to be nonpublic,—and who did not act in good faith in so doing—did not also trade on the basis of that information.

Id. at 21a. The court thus found that "on the facts of this case, no reasonable jury could have made such a distinction." *Ibid.*

The record supports the court of appeals' assessment. It shows that Teicher traded in eight different stocks after being tipped with material information about each security. In seven cases, Teicher traded within a very short time of receiving the tip, often on the same day and sometimes within minutes. Pet. App. 4a-10a. Frankel likewise traded shortly after being tipped. *Id.* at 8a. The district court specifically instructed the jury that it is

not unlawful "for a person to use his superior financial or expert analysis or his educated guesses or predictions or his past practices or experience to determine what stocks to purchase or to sell," or "for a person to buy or sell stocks based on rumors, gossip, stories, or any other source of information consisting of unverified, unsubstantiated information." *Id.* at 20a. Because the jury was required to find that petitioners did not rely on any of those lawful sources of information in order to convict, it necessarily found that petitioners had traded on the basis of information that they knew was unlawfully acquired.

In sum, all that the court of appeals held was that where the defendants' business is trading stocks based on accumulating as much information as possible; where by their own admission they sought out whatever tidbits of information they could obtain to assist in that task; where they knowingly had in their hands material information relating to the stock; and where they did not present as their theory of defense that they did not rely on the information, a rational jury that returned a verdict of guilty under the instructions given must have concluded that the information was a basis for their trades. See Pet. App. 19a-21a. The question whether that determination was correct does not have importance that transcends the facts of this case.[9]

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[9] Even if the court of appeals had ruled that it violates Rule 10b-5 to trade in securities while in knowing possession of material non-public information that was wrongfully acquired, this Court's review would not be warranted, since such a holding would be correct. Material information in the mind of a securities trader is inevitably used in the process of a trading decision, for, as the court of appeals stated, "[u]nlike a loaded weapon which may stand ready but unused, material information can not lay idle in the human brain." Pet. App. 19a. The adoption of a knowing possession standard would not conflict with any decision of another court. As the

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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OCTOBER 1993

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court of appeals noted, petitioner's "argument [for a causal-connection standard] is a novel one," relying on cases from other circuits "which describe securities charges with phrases such as 'trading on the basis of' [inside information] but which did not address the possibility that the trading was *not* causally connected to the inside information." *Id.* at 16a-17a.